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The U.S. Move to International Accounting Standards – A Matter of Cultural Discord – How do we Reconcile?

NEAL F. NEWMAN*

“Convergence is, from the accounting and financial reporting world’s viewpoint, the single most important thing in the history of the world.”¹

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1. Wayne Carnall, Chief Accountant, Division of Enforcement, Securities and Exchange Commission (“SEC”). For background information regarding Wayne Carnall, see Press Release, U.S. Sec. and Exch. Comm’n, Wayne Carnall Named Chief Accountant in Division of Corporate Finance (Nov. 20, 2007), available at <http://www.sec.gov/news/press/2007/2007-239.htm>.

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I. INTRODUCTION

We live in a world that continues to evolve. Technology continues to break down walls and transcend barriers. Today, investors, issuers, and other market participants can engage in financial transactions across national boundaries and make investments, capital allocations, and financing decisions on a global basis more

readily than ever before. This is due in large measure to today's ever-faster communications and ever-more-closely linked markets.² What has not kept pace with this global transformation, however, is the language by which companies communicate, the language of accounting and financial reporting.

What exists presently is a worldwide accounting structure consisting of two major regimes. U.S. Generally Accepted Accounting Principles ("U.S. GAAP" or "GAAP") governs companies formed and operating inside the United States.³ All publicly held companies registered with the SEC must prepare and present their financial statements in accordance with U.S. GAAP.⁴ The other major accounting regime is International Financial Reporting Standards ("IFRS"). To date, over 100 countries have adopted and now use some form of IFRS.⁵

It is inefficient for two major accounting standards to govern provinces around the world. Currently, U.S. issuers operate under one set of accounting standards, and a large part of the world operates under some customized version of IFRS.⁶ Likewise, global companies operating within different accounting provinces must often use different accounting standards for each of the jurisdictions in which they operate; a costly, cumbersome, and time

2. Roadmap for the Potential Use of Financial Statements Prepared in Accordance With International Financial Reporting Standards by U.S. Issuers, 73 Fed. Reg. 70,816, 70,818 (proposed Nov. 21, 2008) (to be codified at 17 C.F.R. pts. 210, 229, 230, 240, 244, 249) [hereinafter IFRS Roadmap], available at <http://www.sec.gov/rules/proposed/2008/33-8982fr.pdf>.

3. IFRS Roadmap, *supra* note 2, at 70,819.

4. IFRS Roadmap, *supra* note 2.

5. IFRS Roadmap, *supra* note 2.

6. The term "customized" refers to the fact that local provinces at times will adopt IFRS standards but will then revise those standards to fit provincial preferences. See Deloitte Touche Tohmatsu, Use of IFRS by Jurisdiction, <http://www.iasplus.com/country/useias.htm> (last visited Mar. 3, 2009) (summarizing which companies have adopted IFRS and how the local provinces may have modified those standards from original form as promulgated by the IASB); see also Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1, 21 (2008) ("There is variation in the basis of reporting used. Most companies report using IFRS as published by [the International Accounting Standards Board] (IASB). However, the vast majority of these companies also assert that statements comply with various country-specific variations of IFRS.").

consuming endeavor.⁷ Various entities responsible for the many factions of accounting standard setting and financial reporting, such as the Financial Accounting Standards Board⁸ ("FASB"), the SEC,⁹ and the International Accounting Standards Board¹⁰ ("IASB"), (collectively, "Accounting Standard Setters") have been aware of this issue since the late 1960s¹¹ and have further recognized the need for change.¹² The world's economies have continued to converge, a dynamic which has galvanized the Accounting Standard Setters, prompting them to renew their quest of world

7. See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, 72 Fed. Reg. 37,962, 37,966 (proposed July 11, 2007) [hereinafter IFRS Financial Statement Acceptance], available at <http://www.sec.gov/rules/proposed/2007/33-8818fr.pdf> ("[T]he Commission noted that for issuers wishing to raise capital in more than one country, compliance with differing accounting requirements to be used in the preparation of financial statements increased compliance costs and created inefficiencies.").

8. The FASB is the independent, private-sector body with SEC-delegated authority to draft accounting standards that accord with U.S. GAAP. See Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743 (Apr. 25, 2003) [hereinafter 2003 Policy Statement]; Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150 (Dec. 20, 1973) (expressing the SEC's intent to continue to look to the private sector for leadership in establishing and improving accounting principles and standards through the FASB). For more information about the FASB, see Financial Accounting Standards Board, <http://www.fasb.org> (last visited Apr. 7, 2009).

9. Congress gave the SEC authority under the federal securities laws to establish accounting principles for enterprises falling under its jurisdiction. DAVID R. HERWITZ & MATTHEW J. BARRET, ACCOUNTING FOR LAWYERS 156 (4th ed. 2006).

10. See Welcome to IASB.org, <http://www.iasb.org/home.htm> (last visited Apr. 6, 2009). The IASB is a stand-alone, privately-funded accounting standard-setting body established to develop global standards for financial reporting. *Id.*

11. See IFRS Financial Statement Acceptance, *supra* note 7, at 37,962. The SEC first addressed discrepancies in financial information provided under a foreign basis of accounting in 1967. *Id.*

12. IFRS Roadmap, *supra* note 2, at 70,818 (recognizing that capital markets have become increasingly global in nature, and acknowledging that a single set of standards would increase comparability between companies around the world).

adherence to one set of “high-quality global accounting standards.”¹³

The United States, however, is one of the few remaining provinces that has yet to convert to IFRS.¹⁴ The United States has operated under GAAP since the early 1970s,¹⁵ and the circumstances prompting the United States to consider a change are not necessarily due to glaring deficiencies in U.S. GAAP, but are more attributable to the need for the United States to remain relevant in the global marketplace.¹⁶ The United States is no longer the preferred choice for raising capital. Today, companies can raise needed capital just as easily in London, Hong Kong, or Dubai rather than New York.¹⁷ Consequently, the United States is in the unaccustomed position of “following suit” as worldwide momentum towards adopting IFRS grows daily, and the United States faces the prospect of becoming increasingly less relevant in the world marketplace if it continues to resist the prevailing trends in financial accounting. In November 2008, in what some might interpret as a reactive measure, the SEC proposed making a decision in 2011 to mandate IFRS adoption with a planned phase-in of adoption dates—2014 for larger accelerated filers, 2015 for mid-sized companies, and 2016 for small companies.¹⁸

We must appreciate, however, that in light of recent events, namely the brunt of the economic crisis in the latter part of 2008, the United States and its contemplated conversion to IFRS is a flu-

13. IFRS Roadmap, *supra* note 2, at 70,817.

14. See Deloitte Touche Tohmatsu, Use of IFRS by Jurisdiction, <http://www.iasplus.com/country/useias.htm> (last visited Mar. 3, 2009) (noting which countries have converted to IFRS, and major provinces that have yet to adopt IFRS, including Canada, China, India, Japan and Mexico).

15. See Financial Accounting Standards Board, Facts about FASB, <http://www.fasb.org/facts/> (last visited Mar. 3, 2009) (explaining how U.S. GAAP as we know it today was developed in earnest starting in the early 1970s with the creation of the FASB). The FASB came into existence in 1973 and has been the entity primarily responsible for developing accounting standards in the United States. *Id.*

16. See generally Cunningham, *supra* note 6 (providing a discussion regarding the United States and its quest to stay competitive in the global marketplace as the force driving the United States toward considering conversion to IFRS).

17. Donald C. Langevoort, *U.S. Securities Regulation and Global Competition*, 3 VA. L. & BUS. REV., 191, 195 (2008).

18. IFRS Roadmap, *supra* note 2, at 70,824.

id situation. The incumbent Obama administration has in fact hinted that it will revisit projects such as IFRS as well as other financial and regulatory matters, although, to date, the administration has made no firm commitments on the matter.¹⁹ For now, the United States' conversion to IFRS is still a prominent issue, and some see it as a key component in the United States remaining relevant in the global marketplace.²⁰ In that regard, the FASB and the IASB continue their joint convergence effort to develop a common set of "high quality global accounting standards"²¹ to which most provinces having a global footprint ideally would adhere.²²

The United States is now focused on converting to IFRS but it seems as if the United States is either overlooking or superficially dealing with a major variable in the equation: the threshold question of the U.S. suitability for IFRS. Simply put, accounting under IFRS represents a different way of doing things, and asking U.S. issuers to comport with IFRS standards will require drastic changes. The United States is asking its issuers to leave an accounting regime under which they have been operating for several

19. Steven Marcy, *Accounting Principles: Fair Value Controversy to Color Major Accounting Issues in 2009*, SEC. L. DAILY, Jan. 29, 2009. Mary Schapiro, the SEC Chairman designee, expressed hesitation toward moving forward with IFRS. *Id.* She noted that the lack of detail in IFRS standards "leaves much to interpretation," and noted the extraordinary costs that would be involved in converting to IFRS. *Id.* She was not definitive one way or the other, however, observing that there is still strong support on both sides for and against converting to IFRS. *Id.*

20. *Id.* Robert Mednick, retired former chairman of the American Institute of Certified Public Accountants and managing partner of Andersen Worldwide, expressed these sentiments in response to a survey posited to prominent members of the accounting and financial reporting community. *Id.* He and others see U.S. conversion to IFRS as inevitable, with the main issues being the matter of how and when the actual change will occur. *Id.*

21. See A Roadmap for Convergence Between IFRSs and US GAAP—2006-2008 Memorandum of Understanding Between the FASB and the IASB (2006), available at <http://www.iasb.org/NR/rdonlyres/874B63FB-56DB-4B78-B7AF-49BBA18C98D9/0/MoU.pdf>.

22. See Deloitte Touche Tohmatsu, Use of IFRS by Jurisdiction, <http://www.iasplus.com/country/useias.htm> (last visited Mar. 3, 2009) (listing those countries that, to date, have adopted IFRS to varying degrees).

decades²³ and to adopt and apply a methodology that is very different from the accounting world to which they have grown accustomed.

This Article explores this overlooked variable by taking a step back to explore the threshold question of whether IFRS is a suitable companion for the United States and its publicly held corporations. This Article argues that IFRS is a poor fit for the United States, both culturally and demographically. The United States has a shareholder demographic and a corporate culture that would not reconcile well with the principles-based tenants of IFRS. This Article will outline how some entrenched U.S. practices, such as the improper use of incentive-based compensation, and other issues, such as the United States' broad and diverse shareholder base, create impediments to the United States' ability to fully embrace and successfully adopt an accounting regime like IFRS. The overall goal of this Article is to encourage stakeholders in the accounting and financial reporting process to re-examine how they view the financial reporting process and consider what unconventional methods they may employ to achieve better outcomes, regardless of the prevailing accounting regime.

In exploring these issues, this Article proceeds as follows. Part II frames the issue, explaining by analogy the fundamental differences between GAAP and IFRS and what challenges those differences will pose for U.S. issuers applying IFRS. Part III takes the abstract analogy in Part II and puts it into concrete form by analyzing specific GAAP provisions and comparing those provisions with their IFRS corollaries. Part III explains how the standards are different under the two regimes and then explains how these differences may pose challenges for U.S. issuers in the event the United States mandates conversion from GAAP to IFRS. Part IV examines the U.S. financial reporting culture to explain exactly why IFRS may not be a suitable fit for the U.S. issuer. Part IV also highlights certain aspects of the U.S. corporate culture as being root causes in why IFRS may not be a good cultural fit for IFRS. Part V explores possible solutions to these issues and suggests an alternative to the use of incentive-based compensation. Part V proposes the unusual suggestion of incentivizing accurate financial reporting by means of basing a portion of an executive's compen-

23. See Financial Accounting Standards Board, Facts about FASB <http://www.fasb.org/facts/> (last visited Mar. 3, 2009).

sation contingent upon the quality of that corporation's financial reporting. Incentivizing accurate financial reporting admittedly would be a difficult undertaking but is a practice that arguably would properly align incentives and achieve better outcomes in the quality of financial reporting. Part VI concludes by summarizing the arguments and making a final case for corporations using incentive-based compensation to incentivize accurate financial reporting as a means to create a better environment for IFRS in the United States.

II. IFRS: A POOR CULTURAL FIT FOR THE UNITED STATES— FRAMING THE ISSUE

IFRS is not a good cultural fit for U.S. issuers due to fundamental differences between GAAP and IFRS which do not reconcile well. Generally speaking, GAAP is primarily a rules-based accounting regime permeated by quantified numerical thresholds and bright line tests of form.²⁴ A typical U.S. GAAP pronouncement couples the accounting standard with a host of pronounce-

24. See STAFF OF THE U.S. SEC. AND EXCH. COMM'N, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE U.S. FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM (2003) [hereinafter SOX REPORT], available at <http://www.sec.gov/news/studies/principlesbasedstand.htm>. The SEC, pursuant to section 108(d) of the Sarbanes-Oxley Act of 2002, underwent a study exploring the idea of the United States adopting a Principles-Based Accounting System. *Id.* The study cited a number of concerns with the United States' current process of accounting standard setting, including the following:

Contain numerous bright-line tests, which ultimately can be misused by financial engineers as a roadmap to comply with the letter but not the spirit of standards;

Contain numerous exceptions to the principles purportedly underlying the standards, resulting in inconsistencies in accounting treatment of transactions and events with similar economic substance, and;

Further a need and demand for voluminously detailed implementation guidance on the application of the standard, creating complexity in and uncertainty about the application of the standard.

Id. at Part I.A.

ments, interpretive releases, and implementation guidance.²⁵ U.S. GAAP evolved into a regime designed to narrow the scope and define the parameters for most accounting transactions to provide U.S. issuers with bright line tests and clearly chartered road maps to follow for virtually any accounting transaction.²⁶ U.S. GAAP evolved in this fashion because U.S. issuers and their certified public accountants demand as much, as they seek to obviate their burden of making accounting judgments in cases of uncertainty.²⁷

IFRS takes a principles-based accounting approach contrary to the U.S. GAAP's rules-based orientation. The underlying bases of IFRS are standards that are principled in nature²⁸ instead of a set of bright line rules and detailed compliance guidance. The following example will help clarify the distinguishing characteristics between a rules-based and a principles-based standard.

A rules-based standard would read as follows: "*Speed Limit 70.*"²⁹ Accordingly, under this rules-based standard, motorists have a clear guideline to follow. The motorist knows with certainty that as long as he is traveling at a rate of seventy miles per hour or slower, he is operating within the law's confines. A rules-based regime provides certainty, predictability, consistency and, arguably, comparability. Conversely, under a principles-based regime the guideline might be worded something akin to "*Drive at a reasonable rate of speed given the present conditions.*"³⁰ Instead of a bright line (70 miles per hour) that clearly marks a legal versus an illegal rate of speed, under a principles-based regime, no clear outer boundary exists. The onus is then on the motorist to determine

25. See *From The FASB Report*: December 24, 2002, The Revenue Recognition Project, 1–2, http://72.3.243.42/project/tfr_article_dec_2002.pdf (last visited Apr. 7, 2009).

26. See SOX REPORT, *supra* note 24, at Part II.A.

27. William W. Bratton, *Rules, Principles, and the Accounting Crisis in the United States*, 5 EUR. BUS. ORG. L. REV. 7, 30 (2004).

28. See SEC. AND EXCH. COMM'N, SEC CONCEPT RELEASE: INTERNATIONAL ACCOUNTING STANDARDS (2009), available at <http://www.sec.gov/rules/concept/34-42430.htm>.

29. See Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1418 (2007) (explaining the difference between rules-based and principles-based standards using the 55 mile per hour speed limit as an example).

30. *Id.*

a “reasonable rate of speed given the present conditions.” Under this principles-based regime, the motorist now must use both discretion and judgment. The motorist must take into consideration the time of day, the volume of traffic flow, weather conditions, etc., and process this data to make a determination as to what constitutes a “reasonable rate of speed given the present conditions.”

The principles-based guideline elicits several disconcerting uncertainties. What if the motorist’s determination of what speed is reasonable under the circumstances is different than the state trooper’s assessment and the state trooper subsequently cites the motorist for exceeding that “reasonableness?” If the motorist were to contest the ticket, how would a judge determine innocence or guilt? Would “reasonableness” therefore have to be reconstituted to incorporate an array of acceptable speed ranges dictated by external factors such as time of day, weather conditions, and traffic flow? Assuming that such reconstituting did occur, a principles-based guideline would still require the trier of fact to insert his or her judgment to make an assessment as to whether the driver’s actual rate of speed was reasonable.

The above example gives a distilled version of the myriad issues, enforcement dilemmas, and consistency challenges that will befall the U.S. accounting and regulatory system in the more fluid IFRS environment. It is this very dynamic of “fluidity” that posits the question whether IFRS would be a good fit for the U.S. financial and reporting culture absent some of the paradigm shifting suggestions set forth herein.

III. THE GAAP VS. IFRS COMPARISON—A CLOSER LOOK

It is useful first to take a closer look at U.S. GAAP and IFRS to understand how the two regimes differ. At the outset, it is instructive to recognize the differing volumes of information currently comprising U.S. GAAP and IFRS. Presently, U.S. GAAP consists of three volumes comprising some 4,530 pages.³¹ Some of

31. The FASB is currently undertaking a project referred to as “Codification,” in which the FASB is consolidating all authoritative U.S. GAAP into one body of information. See FIN. ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS CODIFICATION™ NOTICE TO CONSTITUENTS (V 1.05) 5 (2009), available at <http://asc.fasb.org/imageRoot/10/5724610.pdf>. On July 1, 2009, the FASB expects to formally approve the Codification as the single source of authoritative U.S. accounting and reporting standards. *Id.* At that time, the Codi-

the FASB rules explaining how to book a single transaction comprise over 700 pages.³² By contrast the volume of information comprising IFRS is much more modest. IFRS standards consist of one 2,719 page publication incorporating eight International Financial Reporting Standards, forty-one International Accounting Standards (“IAS”), and twenty-five pronouncements offering interpretive guidance.³³ Each standard and interpretation is approximately one to eight pages in length.³⁴

A. Debate on the Rules-Based vs. Principles-Based Distinction

To present all sides of the debate, some scholars challenge the notion that U.S. GAAP is strictly a rules-based regime and that IFRS is strictly a principles-based regime.³⁵ Professor Lawrence A. Cunningham argues that U.S. GAAP and IFRS both move along “a continuum rather than precisely fitting . . . into two neat categories.”³⁶ In other words, Professor Cunningham argues that U.S. GAAP and IFRS each have their fair share of both rules-based and principles-based accounting standards, and it is wrong to categorize either regime as exclusively rules-based or principles-based.³⁷ Professor Cunningham has valid points. Designating either accounting regime as exclusively rules-based or exclusively principles-based is an overstatement since there are very few absolutes in the world. However, Professor Cunningham’s contention notwithstanding, it is clear that the two regimes are based on very different underlying premises. U.S. GAAP is still replete with many rules-based accounting standards as the U.S. issuer continues to seek prescriptive guidance to resolve accounting issues with

fication will supersede all then-existing non-SEC accounting and reporting standards. *Id.* Once this effort is finalized, it will make accessing U.S. GAAP a more simplified and streamlined process. *Id.* at 6.

32. Alter Wriston, *The Solution to Scandals? Simpler Rules*, WALL ST. J., Aug. 5, 2002, at A10.

33. See generally INT’L ACCOUNTING STANDARDS BD., INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) INCLUDING INTERNATIONAL ACCOUNTING STANDARDS (IASS) AND INTERPRETATIONS AS APPROVED (2008) [hereinafter IFRS].

34. *Id.* at 1.

35. See generally Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of “Principles-Based Systems” in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411 (2007).

36. *Id.* at 1413.

37. *Id.*

road maps marked as clearly as possible.³⁸ IFRS's underlying premise is that its standards will be "principled" in nature, essentially avoiding bright line tests, alternative accounting treatments, or quantified thresholds.³⁹ IFRS accounting standards intend to give corporations sufficient guidance to capture the "economic essence" of a transaction.⁴⁰ IFRS aims to avoid a mere "check the box" approach to financial reporting and instead requires financial statement preparers be more thoughtful in assuring that what they are reporting in the financial statements is a true and substantive reflection of that corporation's financial position.⁴¹

To help crystallize the debate on this issue, the following sections compare selected U.S. GAAP and IFRS standards to highlight the rules-based versus principles-based distinctions existing between the two regimes. The compared standards tend to have a

38. Compare FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 13 – ACCOUNTING FOR LEASES ¶¶ 6–7 (1976), available at <http://www.fasb.org/pdf/fas13.pdf> (77 pages long, including 13 pages of examples), with INTERNATIONAL ACCOUNTING STANDARD 17: LEASES, in IFRS, *supra* note 33, at 1417 (thirty three pages and two pages of implementation guidance); FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 94 – CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES (23 pages long); INTERNATIONAL ACCOUNTING STANDARD 27: CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS, in IFRS, *supra* note 33, at 1417 (incorporating two pages of guidance).

39. For example, Statement of Financial Accounting No. 13 under U.S. GAAP has a number of bright-line quantifying thresholds that determine when a company can account for an asset as an operating lease versus a capital lease. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13 – ACCOUNTING FOR LEASES ¶¶ 7c–d (1976), available at <http://www.fasb.org/pdf/fas13.pdf>. In contrast, the IFRS corollary, IAS 17, sets forth an accounting standard on the same subject matter but gives no quantifying thresholds. See *International Accounting Standard 17: Leases*, in *supra* note 33, at 1157. For a discussion of the differences between GAAP and IFRS when accounting for leases, see *infra* Part III.B.

40. Each IFRS standard starts by stating the standard's objective. For example, International Accounting Standard 27's stated objectives are "to enhance the relevance, reliability and comparability of the information that a parent entity provides in its separate financial statements and in its consolidated financial statements for a group of entities under its control." *International Accounting Standard 17: Leases*, in IFRS, *supra* note 33, at 1157.

41. *Id.* at 1420.

significant financial statement impact on a corporation's balance sheet and/or income statement.

B. Lease Accounting Treatment—U.S. GAAP vs. IFRS

The accounting standards for leases illustrate how the standards differ under GAAP and IFRS. Prominent items on a corporation's balance sheet are expenditures related to the procurement of property, plant, or equipment.⁴² A corporation may use these items from five to forty-five years.⁴³ Corporations will typically lease these assets on a long-term basis instead of purchasing these items outright because the cash outlay related to these items is often considerable.⁴⁴ Accordingly, the method used to account for these long-term lease obligations can have a significant impact on a corporation's financials.

The threshold question and major issue regarding a lease obligation is whether the corporation will have to account for the transaction as an operating lease or a capital lease, as that determination has a significant impact on what the corporation must report in terms of debt obligations, assets, expenses, etc.⁴⁵ If the transaction is a capital lease, the corporation must account for the transaction as if the corporation is acquiring the asset, which in turn entails reporting a long-term debt obligation on its balance sheet.⁴⁶ The capital lease election affects many key financial ratios that analysts use to determine the corporation's financial health.⁴⁷ Alternatively, if the corporation can account for the transaction as an

42. See Home Depot, Annual Report (Form 10-K), at 37 (Apr. 11, 2005). "Property, Plant & Equipment" (net of accumulated depreciation) represented 56% of Home Depot's total assets. *Id.*

43. See *id.* at 42. For example, Home Depot's depreciation for "Buildings" ranges from ten to forty-five years; depreciation for "Furniture, Fixtures and Equipment" ranges from three to twenty years; and depreciation for "Leasehold Improvements" ranges from five to thirty years. *Id.*

44. See *id.* at 37.

45. See generally FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13—ACCOUNTING FOR LEASES ¶¶ 6–7 (1976), available at <http://www.fasb.org/pdf/fas13.pdf>.

46. See generally *id.* ¶ 10.

47. For example, a key analyst ratio is the debt to equity ratio, which measures the amount of debt in relation to the corporation's equity. DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 348 (4th ed. 2006). When a corporation is required to record a lease as a capital lease, this ratio becomes less favorable. *Id.*

operating lease, the corporation need only expense the lease payments in the period in which the corporation incurs those expenses and can thus avoid including the lease as a long-term debt obligation on its balance sheet.⁴⁸ The lower the reported debt obligation, the better the corporation's perceived financial health.⁴⁹ The corporation's healthy financial perception will presumably produce a corresponding increase in the market price for its shares. Accordingly, the stakes can be high for corporations based on the accounting treatment available, which is contingent upon the transaction's nature.

Overall, accounting for leases under GAAP and IFRS are similar. The GAAP standard has components that use quantified thresholds, whereas the IFRS standard is stated in principled terms only. Both standards look at the transaction's nature and require the issuer to elect the less-favored capital lease treatment if certain criteria are present.⁵⁰ The biggest difference between the two standards (not surprisingly) is the nature of the criteria triggering capital or operating lease accounting treatment. Under U.S. GAAP, the criteria triggering capital lease accounting treatment are quantified thresholds that specifically outline when an issuer may account for a transaction as an operating lease, or when the issuer must elect the less-favored capital lease accounting treatment.⁵¹ By contrast, the standards under the more principally based IFRS do not give quantified measures or thresholds.⁵²

The accounting treatment of leases under GAAP and IFRS are the same in certain situations. If the lease transfers property ownership at the end of the lease term, then both GAAP and IFRS require capital lease accounting treatment.⁵³ Likewise, both standards require capital lease accounting treatment if the lessee has

48. See generally FIN. ACCOUNTING STANDARDS BD., *supra* note 45, ¶ 15.

49. Debt is a fixed payment obligation that the corporation is obliged to repay. HERWITZ & BARRETT, *supra* note 47, at 15–16. Corporations often have to forego or defer opportunities because the corporation must use that cash to satisfy debt obligations. *Id.*

50. *International Accounting Standard 17: Leases*, in IFRS, *supra* note 33, at 1165; FIN. ACCOUNTING STANDARDS BD., *supra* note 45, ¶ 7(a–d).

51. *Id.* ¶¶ 7, 10.

52. *International Accounting Standard 17: Leases*, in IFRS, *supra* note 33, ¶ 10(a)–(e), at 1165.

53. FIN. ACCOUNTING STANDARDS BD., *supra* note 45, ¶ 10.

the option to purchase the asset at a price sufficiently lower than the asset's fair market value on the date the option becomes exercisable.⁵⁴

However, the two standards diverge when the capital versus operating lease determination hinges on the lease term or the lease's value. In these situations GAAP provides bright line criteria and quantified thresholds, whereas IFRS states the same idea but in principled terms. Under GAAP, if the lease term is equal to seventy-five percent or more of the leased property's economic life, then the issuer must account for the lease as a capital lease.⁵⁵ The IFRS equivalent addresses this same lease term issue but without quantification.⁵⁶ IAS 17 requires capital lease accounting treatment if "the lease term is for the *major part* of the economic life of the asset, even if title is not transferred."⁵⁷ GAAP specifically quantifies a property's useful economic life; IFRS requires a corporation to determine the "*major part of the economic life of the asset*."⁵⁸

The other distinction between GAAP and IFRS's accounting treatment of leases deals with the scheduled lease payments required under the lease as compared to the property's fair market value. GAAP requires capital lease accounting treatment if the present value of the lease payments equals ninety percent of the property's fair market value.⁵⁹ A corporation must make this assessment at the lease's inception.⁶⁰ In comparison, the IFRS standard states this regulation in principled terms only. IAS 17 requires capital lease accounting treatment if, at the lease's inception, the present value of the minimum lease payments amounts to at least "*substantially all*" of the fair value of the leased asset.⁶¹

54. FIN. ACCOUNTING STANDARDS BD., *supra* note 45, ¶¶ 5(d), 7(b); *International Accounting Standard 17: Leases*, in IFRS, *supra* note 33, ¶ 10(b) at 1165.

55. FIN. ACCOUNTING STANDARDS BD., *supra* note 45, ¶ 7(c).

56. *International Accounting Standard 17: Leases*, in IFRS, *supra* note 33, ¶ 10(a)–(e).

57. *Id.* ¶ 10 (emphasis added).

58. *Id.* (emphasis added).

59. FIN. ACCOUNTING STANDARDS BD., *supra* note 45, ¶ 7(d).

60. *Id.*

61. *International Accounting Standard 17: Leases*, in IFRS, *supra* note 33, ¶ 10 (emphasis added).

It is likely that U.S. issuers would account for leases under IFRS guidelines by tracking closely the quantified thresholds already established under U.S. GAAP,⁶² but it will be interesting to see how U.S. issuers will actually apply the IFRS standard related to leases when the quantified thresholds under U.S. GAAP no longer exist. Will the U.S. issuer view the less-prescriptive IFRS guideline as an opportunity to push that outer boundary even further? Again, what happens when the issuer's assessment as to what constitutes a "major part of the economic life of the asset" is different from the accounting standard setters' assessments?

C. Revenue Recognition—U.S. GAAP vs. IFRS

Revenue recognition is another prominent item in the accounting and financial reporting world and is perhaps the most important item in a corporation's financial statements. A corporation's ability to generate revenue is as vital to that organization's sustained life as the pumping of the human heart. If the corporation fails to generate sufficient revenues to sustain its operations, the corporation will die. Revenue reporting's critical nature makes it inherently prone to abuse, manipulation, or outright fraud.

The foundations for revenue recognition standards under IFRS and U.S. GAAP are similar. Both IFRS and U.S. GAAP do not recognize revenue until it is realized (or realizable) and earned.⁶³ Accordingly, most transactions related to revenue are straightforward, and any distinctions between IFRS and U.S. GAAP are inapplicable. In the basic scenario for the sale of goods, for example, recognizing revenue is proper when the goods in question have been delivered to or purchased by the buyer, and the seller has relinquished all the risks and rewards of ownership.⁶⁴

62. See ERNST & YOUNG, U.S. GAAP v. IFRS: THE BASICS 24 (2007), available at http://www2.eycom.ch/publications/items/2007_ey_us_gaap_v_ifrs_basics/2007_ey_us_gaap_v_ifrs_basics.pdf. "In practice, while FAS 13 specifies bright lines in certain instances (for example 75% of economic life), IAS 17's general principles are interpreted similarly to the bright lines tests. As a result, lease classification is often the same under FAS 13 and IAS 17." *Id.* at 21.

63. See SEC Staff Accounting Bulletin No. 104, 68 Fed. Reg. 74,436, 74,437 (2003) [hereinafter SEC Staff Bulletin No. 104]; *International Accounting Standard 18: Revenue*, in IFRS, *supra* note 33, ¶14(a)–(c).

64. SEC Staff Bulletin No. 104, *supra* note 63, at 74,437 ("An entity's revenue-earning activities involve delivering or producing goods, rendering

Likewise, in rendering services, recognizing revenue is appropriate when the services in question have been performed.⁶⁵ Accordingly, under IFRS or U.S. GAAP, the general standards under either regime will cover many transactions.

Nevertheless, there are significant differences between revenue recognition under IFRS and U.S. GAAP which can lead to significant differences in reported revenues under the two regimes.⁶⁶ For example, U.S. GAAP has more than 140 pieces of authoritative literature relating to revenue recognition.⁶⁷ U.S. GAAP provides both general⁶⁸ and industry specific guidelines on revenue recognition.⁶⁹ Additionally, under U.S. GAAP there are a number of different accounting constituencies, each with different degrees of authority that weigh in on the matter of revenue recognition.⁷⁰ Each pronouncement “focuses on a specific practice problem and has a narrow scope, and the guidance is not always consistent across pronouncements.”⁷¹

services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.”); see *International Accounting Standard 18: Revenue*, in IFRS, *supra* note 33, ¶ 20.

65. See SEC Staff Bulletin No. 104, *supra* note 63, at 74,437; *International Accounting Standard 18: Revenue*, in IFRS, *supra* note 33, ¶ 21.

66. Cunningham, *supra* note 6, at 20–21 (noting that out of the 130 SEC Filings covering fiscal year 2006 by foreign private issuers containing IFRS reports reconciled to U.S. GAAP, only two reported identical income amounts). The variations tended to result in higher IFRS earnings than U.S. GAAP, with eighty-four issuers reporting higher earnings under IFRS, and forty-four issuers reporting lower earnings under IFRS. *Id.* The wide variation is attributable to enduring differences between IFRS and US GAAP. *Id.* at 23.

67. *From The FASB Report*: December 24, 2002, The Revenue Recognition Project 1, http://72.3.243.42/project/tfr_article_dec_2002.pdf (last visited Apr. 7, 2009).

68. See SEC Staff Bulletin No. 104, *supra* note 63, at 74,437. All publicly-held companies must at least follow the guidelines under SEC Staff Accounting Bulletin No. 104. *Id.*

69. *Id.*

70. Shrikant Sortur, *Revenue Recognition*, in THE CHARTERED ACCOUNTANT 1414 (2006), available at http://www.ica.org/resource_file/102531414-1424.pdf.

71. *Id.* “Those pronouncements include Accounting Principles Board (APB) Opinions, FASB Statements, American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guides, AICPA Statements of Posi-

By contrast, IAS 18, in keeping true to accounting standards that are principled in nature, covers revenue recognition in three broad categories: the sale of goods, the rendering of services, and the revenue generated from interest, royalties, and dividends.⁷² Unlike GAAP, IFRS does not provide industry specific accounting guidelines. IFRS does not include guidelines for accounting for performance of construction type and certain production type contracts⁷³ or accounting for revenue arrangements with multiple deliverables.⁷⁴

Accordingly, U.S. GAAP indoctrinates U.S. corporations in an accounting regime that provides pronouncements, bulletins, and guidelines for a myriad of cross-industry and revenue recognition scenarios. If the United States adopted IFRS, U.S. issuers would move from an accounting system that has a pronouncement, bulletin, interpretation, or guideline for virtually any revenue recognition issue imaginable, to an accounting regime that separates the complex issue of revenue recognition into three broad categories.⁷⁵

Old habits can be hard to break, and in spite of the efforts to convert to the global standards under IFRS, U.S. issuers may be resistant to the more murky IFRS and its principles-based standards. Once the United States begins to implement IFRS, it is likely that U.S. issuers will continually challenge the principles-based standards relating to revenue recognition, lobbying both the SEC and the FASB to provide more interpretive guidance and more industry specific guidance to fit their industry specific or customized needs. Consequently, the simple principles relating to revenue recognition under IFRS could eventually mushroom, morph, and revert back to the very accounting regime from which the United States is considering severing ties. While these assessments are

tions (SOPs), FASB Interpretations, Emerging Issues Task Force (EITF) Issues and SEC Staff Accounting Bulletins (SAB) and the like." *Id.*

72. See *International Accounting Standard 18: Revenue*, in IFRS, *supra* note 33, ¶¶ 14–33.

73. See AICPA Statements of Positions (SOP) 81-1.

74. See FIN. ACCOUNTING STANDARDS BD., EMERGING ISSUES TASK FORCE, REVENUE ARRANGEMENTS WITH MULTIPLE DELIVERIES (2003), *available at* <http://www.fasb.org/pdf/abs00-21.pdf>.

75. See *International Accounting Standard 18: Revenue*, in IFRS, *supra* note 33, ¶¶ 14, 20, 29.

speculative, this conclusion is based on the present U.S. financial reporting culture. Many U.S. issuers are still wary of the accounting scandals of the past, and public company auditors and regulators continue to maintain a heightened vigilance for accounting scandals, fraud, impropriety, and other disclosure issues.⁷⁶ Consequently, absent an appropriate comfort level, those involved with the accounting and financial reporting processes may be leery about letting go of the many guideposts and road maps comprising U.S. GAAP to venture out into the more principles-based and less detail oriented IFRS regime.

D. Consolidations—U.S. GAAP vs. IFRS

Financial reporting of affiliated entities on a consolidated basis is another prominent financial reporting area, as this also has a significant impact on a corporation's balance sheet. The major sub-issue under this broad consolidation area is accounting for Special Purpose Entities ("SPEs"). SPEs are legal entities such as corporations, trusts, or partnerships that are established for a specific or limited purpose. SPEs can be used in a number of different contexts. One of the more common SPE uses is asset securitizations, a process by which securities are created whose payments are supported by cash flows generated by a pool of financial assets.⁷⁷

Generally, a corporation will try to structure transactions to avoid reporting SPEs on a consolidated basis because of the adverse impact such accounting treatment may have on its financial statements. Corporations place large debt obligations into SPEs to

76. See, e.g., Krysten Crawford, *Ex-Tyco CEO Kozlowski Found Guilty—Second Trial Ends in Guilty Verdicts for Former Tyco Chief and the Company's Ex-CFO Swartz*, CNN/MONEY, June 21, 2005, http://money.cnn.com/2005/06/17/news/newsmakers/tyco_trialoutcome/index.htm; Joseph McCafferty, *Adelphia Comes Clean—Can Vanessa Wittman Help Bring Scandal-Wracked Adelphia out of Bankruptcy—and Back into Investor's Good Graces?*, CFO.COM, Dec. 1, 2003, <http://www.cfo.com/printable/article.cfm/3011051#>; Jake Ulick, *WorldCom's Financial Bomb—From the President on Down, Officials Worried About Investor Confidence Weigh In*, CNN/MONEY, June 26, 2002, <http://money.cnn.com/2002/06/25/news/worldcom/index.htm>.

77. See THE BOND MARKET ASS'N, INT'L SWAPS & DERIVATIVES ASS'N, SEC INDUS. ASS'N, SPECIAL PURPOSE ENTITIES (SPEs) AND THE SECURITIZATION MARKETS 1–2 (2002), available at <http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf>.

avoid reporting those obligations on their own financial statements.⁷⁸ Nevertheless, if accounting rules require the corporation to consolidate the SPE, then the corporation's financials will reflect the debt obligation regardless.⁷⁹ Corporations then will attempt to structure their SPE transactions to avoid SPE consolidation whenever possible. Subsequently, SPE accounting guidelines garnered much attention in the United States, as cries for change resounded. In 2003, the FASB developed Financial Interpretation 46(R) ("FIN 46(R)"), an accounting interpretation that created a new consolidation model for SPEs.⁸⁰ Prior to the FASB's development of FIN 46(R), corporations were required to report affiliated entities on a consolidated basis if the reporting entity held majority voting control over the affiliated entity.⁸¹

FIN 46(R) created a new consolidation model,⁸² the variable interest model, to broaden the SPE consolidation net to prevent, among other things, the type of financial engineering that occurred with Enron.⁸³ The idea behind the broadened model was to force companies to report debt-laden SPEs on a consolidated basis if in fact the reporting entity had exposure to the obligations transacted through the SPE.⁸⁴ FIN 46(R) veered away from consolidation criteria premised primarily on control. Under FIN 46(R), a company exposed to a majority of another entity's expected losses or entitled to a majority of an entity's expected residual returns must

78. As a result of U.S. issuers' failure to report SPE obligations on a consolidated basis, the FASB developed a new accounting interpretation, Financial Interpretation 46(R). See U.S. SEC. AND EXCH. COMM'N, OFFICE OF THE CHIEF ACCOUNTANT, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(C) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 91 (2003) [hereinafter SPE REPORT], available at <http://www.sec.gov/news/studies/soxoffbalancerpt.pdf>.

79. *Id.*

80. *Id.*

81. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 94—CONSOLIDATION OF ALL MAJORITY OWNED SUBSIDIARIES ¶¶ 6–7 (1976), available at http://www.fasb.org/pdf/aop_FAS94.pdf.

82. SPE REPORT, *supra* note 78, at 91.

83. See generally *United States v. Arthur Anderson, LLP*, 374 F.3d 281 (2004) (explaining how Enron created surrogate companies to engage in off-balance-sheet transactions).

84. SPE REPORT, *supra* note 78, at 91.

report that SPE on a consolidated basis.⁸⁵ Consolidation under the variable interest model, therefore, is based on the general notion of expected benefits or losses inuring to the reporting entity rather than the more rigid notion of voting control through common stock ownership.⁸⁶

Consolidation under the IFRS accounting regime, by contrast, is based on the broader and less complex idea of control.⁸⁷ The IFRS corollary related to consolidations is IAS 27: *Consolidated and Separate Financial Statements*,⁸⁸ and its interpretive corollary, SIC Interpretation 12: *Consolidation—Special Purpose Entities* (“SIC-12”), which gives specific guidance on consolidation criteria related to SPEs.⁸⁹ IFRS requires consolidation when the reporting entity has “control” over the investee.⁹⁰ The consolidation decision under IFRS operates essentially on a tiered system. The top tier, majority voting rights, is the most straight forward indicia of control.⁹¹ From there, the standards and interpretations work their way down to more tenuous but still tangible indications of control.

SIC-12 was promulgated to give guidance specifically for SPE consolidations.⁹² SIC-12 requires consolidation if:

- (1) The SPE conducts its activities to meet the reporting entity’s specific needs so that the reporting entity obtains benefits from the SPE’s operation;⁹³
- (2) The reporting entity has decision-making powers to obtain majority benefits from the SPE’s activities;⁹⁴

85. PRICEWATERHOUSECOOPERS, SIC-12 AND FIN 46R – THE SUBSTANCE OF CONTROL 5 (2004), available at [http://www.pwc.com/extweb/pwcpublishations.nsf/docid/23715FBD1CE6199980256F9C003614A0/\\$file/SIC12_FIN46R.pdf](http://www.pwc.com/extweb/pwcpublishations.nsf/docid/23715FBD1CE6199980256F9C003614A0/$file/SIC12_FIN46R.pdf).

86. *Id.*

87. *Id.*

88. See IFRS, *supra* note 33, at 1417.

89. IFRS, *supra* note 33, at 2555.

90. *International Accounting Standard 27: Consolidated and Separate Financial Statements*, in IFRS, *supra* note 33, ¶ 13.

91. *Id.*

92. *SIC Interpretation 12: Consolidation—Special Purpose Entities*, in IFRS, *supra* note 33, ¶10(a).

93. *Id.*

(3) The reporting entity is able to obtain the majority of the SPE's benefits through an "auto-pilot" mechanism;⁹⁵

(4) By having a right to the majority of the SPE's benefits, the reporting entity is exposed to the SPE's business risks incident to the SPE's activities;⁹⁶ and

(5) The reporting entity retains a majority residual or ownership risk related to the SPE or its assets to obtain benefits from the SPE's activities.⁹⁷

Again, if any one of these criteria is present under IFRS accounting standards, IFRS will require the reporting entity to report the SPE on a consolidated basis.

Under the more principles-based IFRS standards, the issuer must apply much more judgment regarding the decision whether to consolidate a particular set of SPEs. The concern then, is how U.S. issuers will handle this more judgment-oriented principles-based approach, especially in light of the U.S. issuer's strong propensity to avoid reporting SPEs on a consolidated basis if there is possible interpretive wriggle room.

1. Applying the Consolidation Guidance—IFRS vs. U.S. GAAP

Although the IFRS guidance related to consolidations is still relatively new, the SEC is gaining insight as to how the implementation of consolidation guidance works under IFRS versus U.S. GAAP. Accounting representatives on behalf of various constituencies spoke at an SEC roundtable discussion held on August 4, 2008 ("the Roundtable").⁹⁸ It was at the Roundtable that representatives discussed their companies' experiences in trying to account for a set of transactions under IFRS that they had previously accounted for under U.S. GAAP. The results were telling.

94. *Id.*

95. *Id.* ¶ 10(b).

96. *Id.* ¶ 10(c).

97. *Id.* ¶ 10(d).

98. *Policy & Practice—International Convergence—Consolidation Decisions Are Proving Difficult Under GAAP and IFRS, SEC Panelists Say*, 4 BNA TAX & ACCOUNTING 16 (2008).

The German financial institution, Deutsche Bank AG (“Deutsche Bank”) gave their account of the issues they encountered in converting from U.S. GAAP to IFRS.⁹⁹ Charlotte Jones, managing director and global head of the accounting policy group at Deutsche Bank, pointed out that her company’s shift to IFRS “required much more work and analysis in deciding what to derecognize or consolidate back on the balance sheet when analyzing asset-backed securities.”¹⁰⁰ Ms. Jones revealed that Deutsche Bank’s shift to IFRS required the Bank to consolidate some 200 entities that previously did not require consolidation under U.S. GAAP. Ms. Jones discussed the added dimensions to Deutsche Bank’s decision-making process when they were asked to consider their SPE transactions under IFRS.¹⁰¹ Ms. Jones explained that “the use of IFRS required Deutsche Bank to ‘step back, look at the entity in its entirety [and] look at the assets and liability arrangements within them.’”¹⁰² Ms. Jones noted that IFRS “required a much more holistic, better understanding of the risks and benefits [of the investment vehicles] and the bank’s relationship with them.” She explained that “reliance on IFRS guidance in assessing SPEs and consolidation issues around them created more work, in that you could never rely on any specific rules to give you a ‘yes’ or ‘no’ answer unlike some aspects of U.S. GAAP.”¹⁰³ Ms. Jones further explained Deutsche Bank’s need to understand fully the nature of the assets and liabilities being transferred to the SPEs.¹⁰⁴ Ms. Jones noted, however, that even though accounting for the transactions under IFRS was more difficult than accounting for the same transactions under U.S. GAAP, she felt that reporting under IFRS did a better job of capturing the economic substance of the relationship between Deutsche Bank and its affiliated SPEs. Ms. Jones also noted that because IFRS was less mature than GAAP, there was “less of a track record” to reference for guidance. She noted how that circumstance necessitated Deutsche Bank’s need to

99. Marcy, *supra* note 20. Germany, along with the other sovereign nations comprising the European Union, converted from U.S. GAAP to IFRS in 2005. See Andreas M. Fleckner, *FASB and IASB: Dependence Despite Independence*, 3 VA. L. & BUS. REV. 275, 306 (2008).

100. Marcy, *supra* note 19.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

exercise judgment which made the SPE consolidation decision more difficult under IFRS.¹⁰⁵

2. Foreseeable Challenges for U.S. Issuers

Although Deutsche Bank's experience in converting from U.S. GAAP to IFRS is a localized example consisting of just one institution, from this example one can draw inferences and make general assessments regarding foreseeable challenges for U.S. issuers. In their process of converting from U.S. GAAP to IFRS, IFRS required Deutsche Bank to bring some 200 entities back onto its balance sheet.¹⁰⁶ Although Ms. Jones did not quantify this consolidation effort's financial impact on Deutsche Bank's balance sheet, it is reasonable to infer that the dollar amount was significant. The next step then is to speculate what U.S. issuers' experiences might be with a similar consolidation issue when they are asked to interpret and apply IFRS to that transaction. How will the judgment oriented consolidation analysis required under IFRS square with a U.S. corporate culture that, among other things, is sensitive to transactions that may have an adverse affect on U.S. issuer balance sheets?

Accordingly, the first "implementation challenge" with U.S. issuers adopting IFRS will be to overcome the present paradigm that permeates U.S. issuers and their approach to financial reporting. The present paradigm is a financial reporting culture whose focus is not on capturing a transaction's economic substance, but instead, is focused on presenting financial information in as favorable a light as possible while staying within GAAP's prescriptive guidelines.¹⁰⁷ U.S. issuers are sensitive to how certain transactions are going to affect their financials and are ever leery of shareholder action to bad financial news. Such concerns can be a backdrop for the U.S. issuer's approach to every consolidation decision.

The most extreme example of this U.S. issuer sensitivity is Enron's use of SPEs to create fictitious revenues and hide millions of dollars worth of debt. Enron, among other reasons, engaged in their creative (though fraudulent) SPE use to meet a two-fold need:

105. *Id.*

106. *Id.*

107. Bratton, *supra* note 27, at 10.

(i) its need for cash, and (ii) its need to maintain an investment grade credit rating.¹⁰⁸ Enron was reluctant to issue additional equity shares in the company, fearing such actions would create adverse effects on its stock price.¹⁰⁹ Enron's creative use of the SPE was their chosen alternative. However, there are other less-pronounced instances in which U.S. issuers have either pushed the financial reporting envelope or structured a potential consolidating transaction in a manner to avoid consolidation.¹¹⁰

In sum, the concern is whether the U.S. issuer has the proper mind set to apply the more principles-based standards under IFRS in the manner that such standards contemplate. IFRS accounting standards are premised on the basis that individuals will apply such standards with the goal and intent of engaging in financial reporting that captures the "economic substance" of those transactions.¹¹¹ At this juncture, that assumption is premature. U.S. issuers have demonstrated historically that their intent is not necessarily to get the numbers "right" but to present their company's financial position as favorably as possible without running afoul of the accounting guidance in that particular area.¹¹² The voluminous amount of accounting literature that now comprises U.S. GAAP results from this dynamic. GAAP's rules oriented nature is merely the by-product of U.S. issuer demand for accounting standards with clear bright lines that delineate "safe" from "now

108. See Second Interim Report of Neal Batson, Court-Appointed Examiner, *In re Enron Corp., et al.*, Debtors, 349 B.R. 115, No. 01-16034, (Bankr. S.D.N.Y. Jan. 21, 2003) 2003 WL 22048179. As a result of Enron's failure to report the debt obligations contained in the SPEs that they created, Enron's debt obligations as of December 31, 2001 were under reported by \$11.9 billion. *Id.*

109. *Id.*

110. See NOMURA, OFF-BALANCE SHEET UPDATE (2003), available at http://www.adelsonandjacob.com/pubs/OffBalance_Sheet_Update_March_2003.pdf (discussing the effects of U.S. Issuers adopting FIN 46 and how corporations are investigating potential strategies for avoiding consolidation under FIN 46).

111. See SEC. AND EXCH. COMM'N, *supra* note 28.

112. See SOX REPORT, *supra* note 24, § I.C. (noting how the rules-based standards under GAAP provided issuers with a roadmap to avoidance of the accounting objectives inherent in the rules-based GAAP standards). The SOX REPORT tasked the SEC to explore the viability of a revised accounting regime; one that interestingly would have been similar to IFRS. *Id.*

you've gone too far."¹¹³ Accordingly, the problem with trying to integrate IFRS is that the integration would have to go against the grain of these entrenched practices. Simply introducing a different type of accounting regime will not change that situation.

3. The Auditor's Perspective

At the Roundtable, Kenneth Marshall, the Americas IFRS leader for Ernst & Young,¹¹⁴ set forth an auditor's perspective on the difficulties in applying IAS-27 and SIC-12. Mr. Marshall lamented about the difficulties issuers face under IFRS in determining who ultimately controls a particular SPE. Mr. Marshall noted that different issuers will have a different perspective on what constitutes control—the implication being that issuers could come to different consolidation decisions for similar transactions. Mr. Marshall then suggested that more principled guidance should be given on how to assess the rewards and risks potential under SIC-12.¹¹⁵ Trevor Harris, the managing chairman and vice chairman at Morgan Stanley took issue with Mr. Marshall's comments and observations and expressed his view that efforts to obtain more guidance on applying IAS-27 and SIC-12 were "perturbing."¹¹⁶ As he explained, calling for more implementation guidance was, in essence, a push for more "bright lines" that will remove the focus on the likelihood of an asset or liability deterioration, which would be a major determinant on when to force an SPE back onto a balance sheet.¹¹⁷

113. See Bratton, *supra* note 27, at 28 (discussing the dynamic between the public accountant performing the audit and the client being audited wherein the client will challenge a particular accounting treatment with the assertion "Show me where it says I can't do this").

114. Ernst & Young is one of the four remaining international public accounting firms that typically perform the required audits on the larger U.S. corporations and the larger companies around the world. See SmartPros.com, Big Four Auditing Firms, <http://accounting.smartpros.com/x56225.xml> (last visited Apr. 2, 2009) (noting that the global "Big Four Auditing Firms" handle the vast majority of audits for publicly traded companies and private companies worldwide). The website lists PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young, and KPMG as comprising the "Big Four." *Id.*

115. See Marcy, *supra* note 19.

116. Marcy, *supra* note 19.

117. *Id.*

The dialogue between Mr. Marshall and Mr. Harris is but a harbinger of the problems that loom when U.S. issuers attempt to phase in and apply the tenants of IFRS. Inevitably, situations will arise where the U.S. issuer will have to apply IFRS's consolidation standards to a set of transactions necessitating a tremendous amount of judgment to determine the appropriate accounting treatment. From the Roundtable discussion, one can foresee how the U.S. issuer dealing in the gray areas that underlie IFRS might push for black and white standards.

IV. THE U.S. FINANCIAL REPORTING CULTURE— PIERCING TO ITS ORIGINS

It is clear that U.S. conversion to IFRS will be difficult, but the tougher proposition is articulating why such a transition will be so difficult. When scholars, policy-makers, and standard setters attempt to address an issue steeped in regulations, rules, pronouncements, and guidelines, the challenge in addressing and ultimately solving the problem is to zero in on the actual problem instead of continuing to be distracted by the symptoms.

A national economy and, to an even greater extent, a global economy consist of a myriad of commingled, interconnected parts, which co-exist in symbiotic relationships. An economy in its most basic form has providers of goods and services and users of goods and services. Individuals participate exclusively and collectively in this dynamic, acting at various points in time as either providers or users of these goods and services. At its core level, there is an interdependency and connectedness in this global economy that all participants share.

Viewing a corporation as a hierarchy, the executives sit atop the pyramid with the task of overseeing the proper execution of the corporation's strategic vision. The other major constituency, which can perhaps be seen as the opposing dynamic, are the corporation's shareholders. In theory, these two factions have the same objective: profit maximization for the corporation. If the corporation experiences general success, then these two individual factions will usually get along.

In practice, however, the relationship between shareholders and executives can be tense, with each faction pulling in opposite directions. In the broadest sense, the shareholders are the collective owners of the corporation who elect the corporation's board of directors. The board of directors hires or appoints a cadre of ex-

executives who will set and execute that corporation's strategic plan. Consequently, the shareholders' success is contingent upon the executives' ability to and success in setting and executing a strategic business plan that is profitable. In theory, this is a straightforward concept which should produce positive and mutually beneficial results for both constituencies. But when the dynamic plays itself out in actual form, a number of "tensions" develop. It is these "tensions" that result in the morphing of a corporate culture and its corresponding accounting regime which has a propensity toward complex accounting standards steeped in bright-line rules and tests occurring whenever and wherever possible.

A. *"Checks and Incentives" for the Executives—Hammers and Nails for the Shareholder*

Posit a hypothetical corporation to examine the relationship between shareholders and executives. The corporation's objective is to operate at a profit maximizing level where the executives and the rank and file are collectively pooling their time, talent, and resources to make the corporation profitable. The problem with this situation is that the shareholder, who has a vested interest in the corporation's profit maximizing activities, has limited involvement in the corporation's day-to-day operations and, in essence, has the opportunity to wield his rights as a shareholder in only a limited set of circumstances.¹¹⁸ At the same time, shareholders can and do have a major impact on and have a significant influence over the corporation in general, and over the executive officers in particular. The relationship works through two basic functions: the use of incentive based compensation and the influence that shareholders wield over that corporation's share value.

118. As a general matter, shareholders of publicly held corporations exercise their voting power in only a limited set of circumstances: (1) to elect the corporation's board of directors; see MODEL BUS. CORP. ACT §§ 8.03, 8.40; (2) to approve fundamental corporate changes such as mergers, acquisitions, or sales of substantially all the corporation's assets; see *id.* §11.04; (3) to approve the board of directors' proposal to dissolve the corporation. See *id.* §14.02. All other activities and powers are vested in the Corporation's board of directors and executive officers. See *id.* §§ 8.01, 8.41.

B. Executive Compensation: Incentive-Based Compensation

Executive compensation in the United States has been a source of great controversy as of late.¹¹⁹ The controversy became even more prominent in light of the financial institutions that fell into dire straits in the latter part of 2008 requiring government rescue to the tune of unprecedented billions.¹²⁰

A component of executive compensation is “incentive-based compensation.” Incentive-based compensation is compensation that a corporation pays to an executive over and above his base salary.¹²¹ This portion of the executive’s compensation is contingent upon the executive meeting some pre-determined performance mark in areas such as revenue, income, market share, etc.¹²² The most popular form of incentive-based compensation is incentive-based compensation in the form of stock options.¹²³

119. The controversy primarily stems from the ever growing pay disparity between corporate CEOs and their rank and file employees. See Meredith R. Conway, *Money for Nothing and Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL’Y 383, 384 (2008) (“In 1980, the average CEO made 42 times the average hourly worker’s pay.”). That number ballooned to 525 times the average hourly worker’s salary by the year 2000. See *id.*

120. See Matthew Karnitschnig, et al., *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 16, 2008, at A1.

121. See The HOME DEPOT, PROXY STATEMENT AND NOTICE OF 2008 ANNUAL MEETING OF SHAREHOLDERS 27 (2008), available at <http://sec.edgar-online.com/home-depot-inc/def-14a-proxy-statementdefinitive/2008/04/11/Section1.aspx>. For fiscal year 2007,

70% of annual incentive compensation for [Home Depot’s] named executive officers was tied to Company financial performance, including achievement of pre-established sales and operating profit objectives as set forth in [Home Depot’s] business plan for the fiscal year A significant portion of equity compensation for [Home Depot’s] named executive officers for Fiscal year 2007 was . . . conditioned on the achievement of specified levels of shareholder return relative to other S&P 500 companies.

Id.

122. *Id.*

123. See *id.* (“[E]quity compensation [for Home Depot’s CEO] for Fiscal year 2007 was delivered solely in the form of performance shares and performance-vested stock options that [could] be exercised only upon attainment of positive share-priced performance of 25% or more from the grant date.”).

Stock options, in their most basic form, work as follows. On a specific date, the grant date, a corporation will grant a corporate employee the option to purchase stock at a *future* point in time.¹²⁴ The most straightforward grant execution method¹²⁵ gives the executive the right to purchase a pre-determined number of corporate shares in the future at the stock's value on the date the corporation grants the stock option.¹²⁶ The philosophy behind this type of incentive-based stock option is that the corporate employee, usually an executive, now has a long-term vested interest in the company. Accordingly, the corporate employee will marshal his time, talent, and abilities to make that company as profitable and successful as possible to increase the value of his stock options.¹²⁷

Incentive-based compensation in the form of stock options then, in theory, is a means of aligning company, executive, and shareholder fortunes. This proposition is based on the underlying assumption that the executive will endeavor to maximize the value of his stock options through no other means but the marshaling of his time, skill, and talents. This, however, is an assumption that is often flawed.

Without chronicling in great detail how this phenomena played out in various U.S. corporations,¹²⁸ the problem with incentive-based compensation is that it fails to consider man's inability to do the right thing if he has to do so at personal sacrifice to himself, specifically those instances in which a corporation experiences declining revenue, declining profits, declining market share, or otherwise recessionary economic conditions, and the executive must decide how to "navigate" these matters through the financial statement reporting process. The decision the executive faces is a difficult one. The executive may choose either option (a): report this poor financial performance accurately and risk suf-

124. See *id.* at 31.

125. The actual grant execution can work in a number of different ways. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123—ACCOUNTING FOR STOCK-BASED COMPENSATION, at FAS123-2, available at http://www.fasb.org/pdf/aop_FAS123.pdf.

126. See THE HOME DEPOT, *supra* note 121, at 27.

127. See *id.*

128. See generally Neal Newman, *The "Carrot" Approach to Accounting Standard Setting*, 16 U. MIAMI BUS. L. REV. 227 (2008).

fering the almost certain adverse affect the information will have on the corporation's share price and value of his stock options; or option (b): engage in the practice of "financial engineering,"¹²⁹ or in some cases commit outright financial fraud to avoid the consequences that stem from bad news reported in the financials. It would be hard to determine the percentage of executives who choose option (a) versus option (b). Even so, one need only take a cursory glance at any publication that tracks SEC enforcement actions related to accounting and financial reporting to appreciate the fact that executives are still engaging in both "financial engineering" or outright accounting fraud at significant levels.

C. The Financial Statements—The Connecting Link Between Shareholders and Executives

Corporate executives and shareholders both have a vested interest in the information depicted in its financial statements as that information directly impacts how the market values that company's worth. This interconnected dynamic creates a financial reporting game with high stakes that ties fortunes collectively to the same set of information.

Accordingly, Accounting Standard Setters and Financial Gatekeepers need to manage the dynamic between executives and their financial statement preparation. Shareholders premise their buy and sell decisions upon sound financial reporting and need to know that the information depicted in a corporation's financial statements is a fair representation of the corporation's financial condition. The problem with the current arrangement is that shareholders are mere bystanders in the financial reporting process. Their share purchase is merely their admission ticket to participate passively in the corporation's success. The necessary watchful eye is the U.S. regulatory regime with the SEC as the central enforcing agency.¹³⁰ The relationship between shareholder and executive can

129. "Financial engineering" occurs when a corporation engages in accounting practices for the sole purpose of achieving accounting results that are not grounded in economic substance. See Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, in ENRON AND BEYOND: TECHNICAL ANALYSIS OF ACCOUNTING, CORPORATE GOVERNANCE AND SECURITIES ISSUES 103, 108-12 (Julia K. Brazelton & Janice C. Ammons eds., 2002) (discussing the use of special purpose entities as financial engineering tools).

130. U.S. Sec. and Exch. Comm'n, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital*

be a contentious one, with the SEC in essence being the intermediary who manages this relationship as effectively as it can using the rules based accounting standards drafted under U.S. GAAP.

D. The U.S. Financial Reporting Culture's Effect on Accounting Standards and Public Company Regulation

When corporate executives have the distorted incentive to engage in either financial engineering or outright accounting fraud, the counter measure to alleviate this situation is to draft accounting standards "defensively," that is, draft the standards in such a way to clearly delineate the line distinguishing between "right" and "wrong." In fact, the current state of U.S. GAAP is a direct result of the "push the envelope" financial reporting culture where the U.S. preparer asks, "How far can I go without going too far?" Accordingly, the sheer momentum of this "push the envelope" regime, in essence, forces standard setters to draw clear lines of demarcation in the accounting sands. The result is a set of accounting standards replete with quantified rules and bright line tests that give the U.S. issuer boundaries.

This whole discussion may beg the questions, "So what? As long as the U.S. issuer reports within the confines of the rules, how is that a problem?" The problem is that in this type of financial reporting and regulatory environment, U.S. corporate culture blurred the big picture of presenting financial statements that are fair economic representations of their respective corporations. Instead, the focus is not necessarily on getting the financial statements right, but on presenting those financial statements as favorably as possible while staying within the accounting standard's confines. This attitude often results in financial statements that are technically correct, but not fair economic depictions of the corporation. Thus, regulators and enforcers often draft accounting standards defensively and engage in heavy-handed enforcement practices as countermeasures to the corporation created problem of incentivizing aggressive accounting and financial reporting.¹³¹ Final-

Formation, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 1, 2009). The Exchange Act of 1934 created the SEC in response to the stock market crash of 1929. *Id.* The stock market crash of 1929 prompted a need for more oversight of publicly traded companies so that corporate dissemination of financial information was a more formalized and regimented process. *Id.*

131. See Superseding Indictment, United States v. Causey, Cr. No. H-04-25 (S-2) (S.D. Tex. 2004), available at

ly, there is the added pressure of the U.S. corporate shareholder who tends to be myopic in nature and will show little patience for corporations that fail to show steady and upward trending financial performance.¹³²

It is the converging of these dynamics that has created a U.S. corporate culture that seems particularly unsuited for the more principles-based accounting regime that comprises IFRS. Consequently, before U.S. corporations can fully embrace and assimilate the less-structured accounting regime of IFRS, the United States must first address these forces that necessarily resist a principles-based regime.

E. The Differences Between Comparable IFRS Provinces and the United States

Prior to implementing IFRS, the United States should take a closer look at provinces that have already adopted IFRS, even though such an exercise may force the United States to ask the tough questions. Is IFRS an accounting regime that is compatible with the U.S. financial reporting culture or should the United States revisit the decision to adopt such a regime? The Obama administration, through its SEC Chairman Mary Schapiro, seems to be taking the right step in asking these questions.¹³³

1. The European Union

To date, over 100 countries, including countries as large as Germany and as small as Anguilla, have adopted some form of IFRS as promulgated by the IASB.¹³⁴ The largest contingency of IFRS adopters is the European Union ("EU"), which consists of

<http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/usvlay70704ind.pdf> (last visited Apr. 1, 2009) (alleging Kenneth Lay, Enron's former CEO and Board Chairman, received approximately \$300 million from the sale of Enron stock options and restricted stock between 1998 and 2001, netting over \$217 million in profit). During that same period, Jeffrey Skilling, Kenneth Lay's successor received approximately \$200 million from the sale of Enron stock options and restricted stock, netting over \$89 million in profit. *Id.*

132. See James Niccolai, *Sun CEO Fends Off Angry Shareholders*, ITWORLD, Nov. 5, 2008, <http://www.itworld.com/business/57278/sun-ceo-fends-angry-shareholders>.

133. Marcy, *supra* note 19.

134. See Deloitte Touche Tohmatsu, *Use of IFRS by Jurisdiction*, <http://www.iasplus.com/country/useias.htm> (last visited Mar. 3, 2009).

some twenty-seven sovereign nations since its *de facto* inception in 1951.¹³⁵ The EU accounts for some \$11 trillion or twenty-six percent of global market capitalization when combined with Australia and Israel.¹³⁶

In 2005, the EU instituted mandatory IFRS adoption for its member states, requiring more than 7,000 companies within the EU to prepare their financial statements in accordance with IFRS.¹³⁷ EU member Germany, with a population of approximately 82 million¹³⁸ and an equity market counted as among the largest in the world,¹³⁹ is a good comparison point for the United States.

2. The United States vs. Germany—Different Demographics

Business capital sources in the United States are different from Germany. This variance in investor demographic alone can create a different emphasis, attitude, and approach in accounting standard setting and financial reporting. A small number of large banks and pension funds comprise the primary shareholder base for German corporations, therefore, corporate ownership and voting rights are concentrated among these larger institutions.¹⁴⁰

By contrast, the capital sources in the United States are much more diffuse. Business capital sources in the United States draw upon large institutional clients such as mutual funds, pension funds, and insurance companies, as well as small retail and individual investors. Individual investors are presumably less sophisticated, and have less informal access to management, but nonetheless comprise a significant portion of U.S. capital investment.¹⁴¹

If the bulk of a country's investment base is large banks and pension funds, as in the case of Germany, the need for a sophisticated, investor-oriented financial reporting system is less

135. See Fleckner, *supra* note 99, at 287.

136. IFRS Roadmap, *supra* note 2, at 70,819.

137. See Fleckner, *supra* note 99, at 287.

138. At the end of 2004, Germany's population was 82.5 million. GermanCulture.com, German Population, http://www.germanculture.com.ua/library/facts/bl_population.htm (last visited Apr. 1, 2009).

139. Carol A. Frost & Kurt P. Ramin, *International Auditing Differences*, 181 J. ACCT. 62, 62 (1996).

140. *Id.*

141. GERHARD G. MUELLER, ET AL., *ACCOUNTING: AN INTERNATIONAL PERSPECTIVE* 4 (4th ed. 1996).

pressing. Pension fund managers and banks can satisfy their need for corporate information in a straightforward fashion as they typically will have direct access to corporate management through personal contacts and direct visits.¹⁴² In contrast, the United States, with a large diffuse investor base that includes both institutional and retail investors, requires a more “paternal” or protective approach to financial reporting and regulation.¹⁴³ Without such protections, the individual investor would have two choices: disengage from capital market investing or invest in a market with a less rigid regulatory net and risk falling through the cracks.

Naturally then, it does not make sense to marginalize U.S. corporations from an investment source comprising billions in equity market participants.¹⁴⁴ Accordingly, U.S. corporate culture in part guides accounting standard setters and regulators to serve the demographic comprising the U.S. capital investor. This results in a more prescriptive rules-based financial reporting regime on the standard setting and regulatory sides. The standard setting side includes bright line tests and quantified thresholds. On the regulatory side, regulators employ a more formalistic, detailed and heavy-handed approach in enforcing accounting standards and mete out severe punishment when transgressors breach such standards.

3. Auditing Standards

Other noteworthy differences between the United States and Germany highlight possible challenges to a U.S. conversion to IFRS. For example, German auditors have less liability exposure

142. *Id.*

143. *Id.*

144. See Lyn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407,430–31 (2002) (“Individual investors, most of whom hold rather small portfolios, own nearly 50 percent of all U.S. corporate equities.”).

Although institutions like mutual funds, pension funds and insurance companies own most of the rest, often these institutions' investment decisions also are influenced by individuals' views of the market: it makes little difference if a mutual fund manager thinks her equity fund a good investment, if individual investors do not agree.

Id.

as Germany has placed caps on damages that may be levied against auditors for negligence. Likewise, the German corporation and their auditors will limit potential liability for all other accounting services by drafting those limitations into their contractual agreements.¹⁴⁵ A lower level of legal exposure for the auditor creates a more relaxed auditing environment. With less at stake in terms of potential liability, the auditor can likewise relax the rules regarding what is “right” and what is “wrong.” A more principles-based accounting regime is more compatible in an environment where the concerns for investor protection are not as high. Lower concern for investor protection coupled with lowered potential liability for the gatekeepers involved in the process creates an environment more compatible to operating in a less prescriptive accounting regime like IFRS.

4. General Business Protocol

Finally, dynamic differences between U.S. and German general business protocol may perhaps lend insight to the foreseeable problematic implementation of IFRS in the United States. A common unifier among people around the world is the fact that we are of one race, the human race. Humans have the same basic needs for food, clothing, shelter, and some type of family unit from which we can draw love and support. However, many cultural differences pervade the human race, and these differences can permeate the simplest things from how we greet each other in the morning to how we view business relationships.

Human dynamics as they may vary in different provinces can also affect cultural and legal norms. For example, the Japanese tend to view business relationships as an extension of, or on a par with, personal and family relationships.¹⁴⁶ In other words, doing business in these cultures is not just about an arm’s length transaction between two parties that may be mutually beneficial. In these cultures, doing business is the result of nurtured and cultivated relationships. Consequently, business people in Japanese

145. See Frost & Ramin, *supra* note 139 (noting that auditors’ legal risk in Germany appears to be growing as evidenced by an increase in publicized audit failures).

146. See JON P. ALSTON & ASAO TAKEI, JAPANESE BUSINESS CULTURE AND PRACTICES: A GUIDE TO TWENTY-FIRST CENTURY JAPANESE BUSINESS PRACTICES 105–06 (2005).

culture spend a lot of time cultivating interpersonal relationships before considering any actual business transaction.¹⁴⁷ In the United States, by contrast, business people generally treat business transactions in more of an arm's length fashion, placing less emphasis on the relationship between the two parties and more emphasis on the mutually beneficial nature of the transaction itself.¹⁴⁸

Similarly, differences in the business relationship between the German issuer and its public auditor versus the U.S. issuer and its public auditor illustrate why a more principles-based accounting regime might be unsuitable for the United States. In Germany, the audit managers tend to be involved with clients over a number of years because German corporations favor consistency in audit personnel.¹⁴⁹ German management considers audit staff changes from year to year as low quality service.¹⁵⁰ U.S. managers on the other hand are less concerned with who does the audit but rather how efficient and cost effective are the auditors in completing their task. Therefore, U.S. companies are less concerned with staff turnover as long as the job is completed on time and under budget.¹⁵¹

One can then appreciate that these dynamics will affect the German auditor's approach in conducting an audit. For example, German audit managers might consider it inappropriate for auditors to question management's oral statements.¹⁵² German management may interpret the auditor's inquiries as the auditor questioning the corporation's integrity and ethical practices, a clear affront or a taboo in Germany.¹⁵³ In contrast, the U.S. auditing firms train their auditors to question management's oral representations.¹⁵⁴ The U.S. manager would not take offense to such ques-

147. *Id.*

148. *Id.* at 106.

149. Frost & Ramin, *supra* note 139, at 63.

150. *Id.*

151. See generally James L. Craig, Jr., *The Business of Public Accounting*, CPA J., Aug. 1994, <http://www.nysscpa.org/cpajournal/old/15702999.htm> (discussing the business of public accounting, business professionals' need to reduce staff, be efficient, and the need to maximize staff productivity).

152. Frost & Ramin, *supra* note 142, at 66.

153. *Id.*

154. See Sample Audit Interview Introduction and Questions, <http://www.nysscpa.org/cpajournal/2005/205/images/p36.pdf> (last visited Apr.

tioning, as he or she would likely view the questioning as the auditor simply doing his job.

V. IFRS - IMPLEMENTATION—TRYING TO FIX THE PROBLEMS

A. *The “Usual Suspects”*

What needs to happen in order for the U.S. conversion from Generally Accepted Accounting Principles to International Financial Reporting Standards to be a smooth transition/implementation? It is here that one must distinguish between actions that address the core of the matter versus actions that only treat the symptoms. One can cull through a great deal of scholarship regarding this topic and note the “usual suspects” as issues to address for successful IFRS implementation, a few of which are worth mentioning. To be clear, however, these items are mentioned merely to make the point that addressing these issues still does not address what is at the core of the U.S. corporate culture that may be a fundamental barrier to the United States’ successful implementation of IFRS.

1. The U.S. Regulatory Environment

The SEC has been under fire as of late for its failure to ferret out monumental frauds such as the recent scandal involving Bernard Madoff’s perpetuation of a \$50 billion ponzi scheme through his investment firm, Bernard L. Madoff Investment Securities LLC.¹⁵⁵ Nonetheless, the United States, through the SEC, is considered one of the more “heavy handed” financial reporting enforcers in the world.¹⁵⁶ Indeed, the United States passed the Sarbanes-Oxley Act in 2002, which required additional overlays of

1, 2009) (including examples of specific training for auditors regarding how the auditor should question management to gather information concerning fraud).

155. See generally Richard Hill, *House Subcommittee Will Probe Madoff Affair; Full Hearing Urged by Minority*, SEC. L. DAILY, Dec. 18, 2008.

156. See Langevoort, *supra* note 17, at 192 (“Various well-publicized, bipartisan blue-ribbon committee reports have criticized U.S. securities regulation for being unduly cumbersome, and in part, blamed overregulation for a loss of competitiveness in the global capital marketplace.”).

corporate accounting and financial reporting compliance.¹⁵⁷ Following the Sarbanes Oxley Act's enactment, many smaller companies had to forego the public capital markets lest they be crushed by Sarbanes' added regulatory burdens.¹⁵⁸

The SEC will have to temper its basis for enforcement actions under a new principles-based accounting regime, whereas a rules-based regime may have more clearly delineated the lines regarding "right" and "wrong" financial reporting. Such previously clear lines will likely blur when the SEC works with financial reporting under IFRS. Accordingly, regulators and enforcers will facilitate a smoother U.S. transition to IFRS if they recalibrate their enforcement regime to allow for more flexibility and a range of possible outcomes, that is, recalibrate what is a "*reasonable rate of speed given the present conditions*."¹⁵⁹

2. Auditor Liability

Ensuring an easier transition from U.S. GAAP to IFRS requires the United States to adjust present auditor liability to account for IFRS's less prescriptive regime. The United States needs to revisit the whole paradigm of circumstances that result in auditor liability, including the notion of "material misstatements" or "material omissions," prior to adopting an accounting regime in which there will conceivably be more than one "right" answer. A new approach should revolve around the auditor's diligence in making sure that the issuer in question made appropriate efforts to record transactions within the principles-based guidelines set forth under IFRS.

3. U.S. Financial Statement Preparers

U.S. corporations are perhaps the most prominent players integral to the success of IFRS. Even though the SEC regulates

157. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 §§ 101-09, 401-09, 116 Stat. 745, 800-10 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, 29 U.S.C.A. (2004)).

158. Sarah Johnson, *Sarbox Getting Costlier for Small Firms—A New Survey from Merrill Lynch Adds Fuel to the Fire for a Sarbox Rollback*, CFO, Dec. 5, 2006, http://www.cfo.com/article.cfm/8376091/c_3666324/?f=archives (last visited Apr. 1, 2009).

159. See discussion *infra* Part II.

financial reporting and the public accountants are on the front lines of this regulatory process, financial statements are ultimately management's responsibility. Correspondingly, U.S. issuers will have to be the driving force behind the implementation of IFRS in order for the new accounting regime to succeed.

B. Something Different—Incentives to get it Right

The United States must address one fundamental core variable in order to create a financial reporting environment receptive to an accounting regime like IFRS. That fundamental variable is the U.S. issuers' mind-set in their approach toward accounting and financial reporting. Principles-based accounting is premised on giving corporate managers the latitude to insure that they capture the "economic substance" of a transaction. Then, one must recognize and appreciate the underlying assumption built into the principles-based regime: managers will focus their efforts on getting the numbers "right" versus mere compliance with bright-line tests of form.

1. At the Core

Academics have the luxury¹⁶⁰ to sit and contemplate that which is wrong in the world and then to posit some supposition as to how to remedy such ills. Though there may be some truth to the adage "every problem has a solution," that solution, whatever it may be, can prove elusive. Another luxury that the academic position affords is the luxury of outside the box thinking, or more accurately, thinking that is not always tethered by what may or may not be viable or practical. If academics fail to push unconventional thinking in the incubated environment of academic scholarship, then we have failed to utilize this platform to its fullest potential. These prefatory comments are included in an effort to adjust the reader's mind-set and open receptivity to an approach that is both unorthodox and cuts sharply against the grain of current business protocol.

2. Incentivizing Accurate Financial Reporting

Presently U.S. issuers in the financial statement preparation process have distorted incentives to financial statement presenta-

160. In fact, it is a precept of our station.

tion. When U.S. issuers prepare their quarterly and annual financial statements, the focus is not necessarily on getting the numbers “right,” but on presenting the financial position of that company as favorably as possible without deviating from the prescriptive parameters set out under U.S. GAAP. The added variable of incentive based compensation in the form of stock options is an additional dynamic that can improperly distort the issuers’ proper focus on financial reporting. Poor financial performance results in a corresponding decrease in market capitalization which, in turn, results in reduced stock option values. It necessarily follows that those who control the financial reporting process will have incentives to distort financial information to avoid the adverse impact that poor financial performance would have on their personal financial stakes when faced with tough financial reporting choices.¹⁶¹ The present incentive-based practices effectively create a “disincentive” for reporting poor information accurately. The challenge then is to change this dynamic and create a paradigm where the executive/ financial statement preparer’s focus remains on reporting financial information accurately *regardless* of whether that information happens to be favorable or unfavorable.

Consider then the following alternative to incentive based compensation. Instead of attempting to incentivize executive performance based on stock options, consider the practice of incentivizing *accurate* financial reporting. In other words, base a portion of an executive’s compensation on the extent to which his corporation’s financial statements fairly present the financial position of his respective company. Consider the reverberating effects that such an action would have. This proposition envisions executives and financial statement preparers with a completely different mindset when engaging in the financial preparation and reporting process. Incentivizing accurate financial reporting would shift the financial statement preparer’s focus from “pushing the numbers” as favorably as possible without stepping outside the bounds of GAAP, to reporting the numbers accurately, regardless of whether that information was favorable or unfavorable. By giving the fi-

161. Review of some high profile accounting scandals reveals that at the core of the scandal were self-serving choices by those operating at the corporation’s executive levels or those who held positions as controlling shareholders. See *supra* note 76 and accompanying text.

nancial statement preparer a stake in quality financial reporting, it is more likely that the financial statements will be a better representation of that company's financial position.

3. Conception to Adoption

The unusual and perhaps novel aspect of this proposal is that it does not suggest different laws, better laws, more restrictive laws, etc. This is an idea rooted in harnessing man's natural tendencies to act in his own self-interest and then channeling this character trait toward producing a desired result. Given that this proposal is not one that is rooted in law, incentivizing accurate financial reporting thus requires a voluntary buy in from all the constituencies involved in the financial reporting process. Corporate boards that oversee and structure executive compensation packages would have to embrace such an approach and then structure executive compensation accordingly.

Additionally, the percentage of executive income apportioned to accurate financial reporting would have to be substantial enough to motivate the executive/financial statement preparer to engage in the desired behavior and fully embrace the concept of accurate financial reporting. If this mark were to be quantified, fifteen to twenty-five percent of an executive's salary would seem adequate while at the same time giving corporations and their board's flexibility and latitude in pegging the right percentage for their particular institution.

C. The Resulting Effect on IFRS Implementation

Incentivizing accurate financial reporting could be the change that accomplishes the ultimate goal of creating a dynamic within the U.S. financial reporting regime that makes it more suitable for IFRS reporting standards. By incentivizing accurate financial reporting, the "push the envelope" reporting practices that exist presently would be removed because the executive's incentives would shift from presenting the financial information as favorably as possible to presenting such information accurately. This change in focus would facilitate greater receptiveness for IFRS standards because U.S. preparers would focus towards capturing the economic substance of a transaction whether that substance is positive or negative.

The reduced pressure on financial statement preparation would trickle down into the enforcement and regulatory environ-

ments as well. Presently, the relationships in the financial reporting process can be characterized as adversarial at best. On one side of the financial reporting process are the accounting standard setters and regulators. The standard setters draft prescriptive rules-based accounting standards to create clearly delineated lines of right and wrong. Likewise, the regulatory enforcers adopt a heavy-handed approach to enforcement in order to create a deterrent effect on both “financial engineering” and the more deviant behavior of accounting fraud. On the other side are the U.S. issuers, the ones ultimately responsible for the information that goes into their financial statements. Their distorted incentives regarding financial statement reporting require more of a “stick” approach to financial regulation in which consequences result when the issuer deviates from prescribed accounting standards.

Incentivizing accurate financial reporting instead creates a “carrot” for U.S. issuers and would presumably place stakeholders and standard setters on the same side of the fence as all constituencies would presumably work toward the same goal of quality financial reporting. In this environment, all factions would develop a more cooperative and collaborative relationship instead of one set of stakeholders (the standard setters and regulators) essentially being the watch-dog over the other set of stakeholders, the U.S. issuers.

D. Opposition to Incentivizing Accurate Financial Reporting

It is expected and anticipated that opposition to such a proposal will be great. The first and biggest suggestion would be its feasibility. Even if all U.S. issuers adopted this proposal would it improve the financial reporting process in general and would it clear the path and create a better financial reporting climate for the U.S. adoption of IFRS? The answer is unclear, but still the present state of affairs needs improvement while financial fraud continues to persist in various forms in spite of the government’s continuous mandate of additional regulatory overlays. President Obama tapped Mary Schapiro to take over the SEC as its next Chairman. She promised to restore faith and confidence in the SEC by renewing the SEC’s commitment to vigorous enforcement.¹⁶² Many appreciate the renewed “get tough on transgressors” speech, but regu-

162. Phyllis Diamond, et al., *Obama Pledges to Reform Landscape; Big Changes Ahead for Schapiro’s SEC*, SEC. L. DAILY, Jan. 26, 2009.

lators will eventually have to accept the fact that a good crook can outsmart a good cop any day of the week. Heavy-handed enforcement only creates savvier, more creative accounting "techniques," most of which are likely to fly under the SEC radar.

The idea behind this proposal is to get to the core of the financial accounting problem: stop questionable financial reporting before it starts. This can be done by creating a dynamic in which those ultimately responsible for financial statement preparation are not trying to engage in financial obfuscation but actually have an incentive to adhere to representational faithfulness in their financial reporting. One definition of insanity is "doing the same thing, over and over again, but expecting different results."¹⁶³ Vigorous, renewed, or more heavy-handed enforcement may catch a few additional transgressors and may cause some to reconsider before actually engaging in questionable accounting. However, true change can only come when we switch from trying to build bigger and better dams to redirecting the water flow all together. Both the paradigm and the mind set must be changed, as well as changing the approach to achieve quality financial reporting. Those striving to improve the quality of financial reporting must question what their resolve is in achieving this objective and the steps they are willing to take to reach this desired result.

VI. CONCLUSION

The United States is contemplating a shift from U.S. GAAP to an accounting regime promulgated by the International Accounting Standards Board referred to as International Financial Reporting Standards. Some believe that this wholesale shift in accounting and financial reporting is a natural and necessary evolution if the United States wishes to remain relevant in a global market place. Over 100 provinces have already made the commitment to switch to IFRS, and the United States is one of the few countries with a major global footprint still contemplating the decision. Some believe the U.S. switch is inevitable, but in light of recent events such as the current economic crisis and the administration change at the White House, the move to IFRS is not the foregone conclusion it once was. If the United States decides to make the definitive move to IFRS, however, then U.S. issuers, regulators,

163. RITA MAE BROWN, *SUDDEN DEATH* 68 (1983).

and standard setters alike will have to look at all aspects of the implementation process. The threshold question of U.S. suitability for IFRS seems to be an issue that has either been overlooked or under appreciated. IFRS supporters are asking U.S. issuers to move away from an accounting regime that has been growing roots since the early 1970s. Such entrenchment will be hard to supplant. This Article argues that a paradigm shift in the approach toward financial reporting will have to occur for a successful U.S. shift to IFRS. Currently, U.S. issuers have distorted incentives when it comes to financial reporting. The use of incentive-based compensation in the form of stock options creates the incentive for U.S. issuers to “push the envelope” in the financial reporting process in order to present the financial statements in as favorable a light as possible. IFRS requires a wholly different mind-set, as IFRS is premised upon the issuer capturing the “economic substance” of a transaction. The U.S. issuer’s motivations and the tenants of IFRS are discordant and it is doubtful that the U.S. issuer will automatically change approaches to financial reporting merely because the United States operates under a different accounting regime. This Article argues that there must be a catalytic event to “push” the U.S. issuer in that direction. Incentivizing accurate financial reporting is one suggested approach. Incentivizing accurate financial reporting will provide the U.S. executive with a vested and personal interest in quality financial reporting versus the prior motivation of presenting the financial statements as favorably as possible to protect the value of his or her stock options. Realigning the incentives realigns the focus in financial reporting, thus creating a better financial and reporting environment more suited for the principles-based tenants of IFRS. Although this proposal may be contrarian, perhaps it is time to forage new paths. Perhaps this is an idea whose time has come.

